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Securities and Exchange Commission
Attn: Nancy M. Morris, Secretary
100 F Street, NE
Washington, D.C. 20549-1090

Re: **File Number S7-11-06**
Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting

Dear Ms. Morris,

Deloitte & Touche LLP is pleased to respond to the request for comments from the Securities and Exchange Commission (the Commission or the SEC) with respect to its Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting [Release No. 34-054122; File No. S7-11-06]. We support the Commission's decision to seek input from the public with respect to this important topic, and we hope the input received will provide helpful insights about guidance needed by management in conducting an assessment of the effectiveness of internal control over financial reporting. The comments provided herein are based on our collective insights and experiences in performing integrated audits. Our insights and experiences include those of the non-U.S. member firms of Deloitte Touche Tohmatsu.

I. Introduction

We support the goals of the Sarbanes-Oxley Act of 2002, and specifically Section 404, which requires both management and the auditor to report on the effectiveness of internal control over financial reporting. We believe investors have greatly benefited from internal control reporting and such reporting by management and the related requirement for the auditor has improved disclosures to investors about internal control related matters, enhanced the reliability of financial statements, and helped reduce the risk of fraud by placing a stronger focus on the establishment and maintenance of effective internal control over financial reporting.

Management's assessment of the effectiveness of internal control over financial reporting fundamentally impacts the auditor's related assessment. Although the auditor is not required by PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements* (AS 2) to specifically opine on the adequacy of management's assessment process, AS 2 does require the auditor to obtain an understanding of and to evaluate management's process.[1] Also, if the auditor determines that management's process for assessing internal control over financial reporting is inadequate, the auditor is required to modify his or

[1] AS 2, paragraph 40.

her opinion for a scope limitation.[2] Additionally, the manner in which management completes its assessment impacts a) the auditor's ability to use the work of management to the extent permitted under the standard; and b) the auditor's evaluation of deficiencies in management's documentation. As such, we believe it is important for us as auditors to provide our insights and suggestions as to the development of guidance relating to management's assessment of internal control over financial reporting.

Below we provide our overall comments, followed by our responses to the specific questions posed in the Concept Release.

II. Overall Comments

Need for Management Guidance

We believe management of many companies could benefit greatly from additional guidance about how to perform an assessment of internal control over financial reporting. We believe that guidance provided should have the overriding objectives of:

- assisting management in performing an effective assessment of internal control over financial reporting;
- assisting in making the requirements scalable for companies of all sizes and complexity; and
- helping companies evaluate internal control over financial reporting in a cost-efficient manner.

In the absence of guidance for management about how to complete its assessment, the elements outlined in AS 2 have become the de facto guidance for issuers for purposes of performing their assessments. Many companies have developed processes around the guidance in AS 2 on evaluating management's assessment process (AS 2, paragraphs 40-44). The elements contained in those paragraphs are conceptually sound and provide an appropriate approach for issuers to follow in performing their assessments. Consequently, we believe that guidance developed by the Commission about the elements that management needs to address in an assessment of internal control over financial reporting and the related documentation considerations should be consistent with the elements outlined in AS 2 and should provide additional practical implementation guidance in those areas that management has found challenging in completing its assessments.

Additional guidance for management would result in increased consistency in management's use of a top-down, risk-based approach to designing, documenting and testing of internal control over financial reporting. Importantly, it would also enable the auditor to better apply a top-down, risk-based approach to the audit of internal control over financial reporting and may allow the auditor to increase the extent of use of management's testing.

Maintain Concepts of Commission's 404 Rules and May 2005 Guidance

The guidance developed by the Commission regarding management's assessment of internal control over financial reporting should maintain the core concepts included in the Commission's original rules implementing Section 404, as well as the guidance that it and its staff issued on May 16, 2005. We believe that the core concepts the Commission should include in the guidance issued are:

[2] AS 2, paragraph 174. Also, refer to AS 2 paragraphs 19-21.

- The design of an issuer's internal control over financial reporting should be documented in an appropriate manner, taking into account the nature, size and complexity of the entity.
- Management's assessment of the effectiveness of internal control over financial reporting should be conducted based on a framework established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.
- Management's assessment should be planned and performed to identify material weaknesses – i.e., control deficiencies that individually or in the aggregate result in a more than remote likelihood that a material misstatement of the annual or interim financial statements would not be prevented or detected.
- Management should obtain reasonable assurance (i.e., a high level of assurance) to support its assessment, and its assessment should be supported by a reasonable level of evidential matter.
- Conclusions reached by the issuer concerning the effectiveness of its internal control over financial reporting at the "as of" reporting date should be based on the premise that the identification of one or more material weaknesses that are not remediated by the "as of" reporting date precludes the issuer from reaching a conclusion that internal control over financial reporting is effective.

Define Common Terms

A common understanding as to the meaning of certain key terms is critical to successful implementation and compliance with the requirements of Section 404. Currently we believe confusion exists regarding the meaning of several terms that are regularly used in connection with 404 assessments. This confusion has resulted in significant misunderstandings by management, auditors, and investors. For instance the following terms are not consistently used: entity-level controls, company-level controls (specifically how they relate to process-level controls), key controls, monitoring, on-going monitoring controls, separate evaluations, and self-assessments.

- With respect to entity-level controls and company-level controls, it is not clear whether these terms are consistently used to refer to the same types of controls or if they are used to refer to two different types of controls. Additionally, there is no common understanding of how company-level controls or entity-level controls compare to and contrast with process-level controls.

- The term key controls, though commonly used, is not a defined term in either the PCAOB or the SEC rules. Moreover this term is not used consistently. In some cases, key controls is intended to mean those controls which alone are sufficient to constitute effective internal control over financial reporting. In other cases, key controls is intended to mean higher level controls that are an important component of effective internal control over financial reporting, but, in and of themselves, do not provide reasonable assurance of preventing or detecting material misstatements of the financial statements.

- There is a lack of common understanding with respect to the terms monitoring, on-going monitoring, self-assessment, and separate evaluations, and it is not clear how these terms inter-relate. For instance, it is not clear whether monitoring and on-going monitoring are used to refer to monitoring of operating results or to monitoring of other controls or to both. Also, it is uncertain whether self-assessments are a form of on-going monitoring, whether separate evaluations, to be objective, should be performed by internal audit and how such activities relate to monitoring.

It would be very helpful if the Commission and the PCAOB jointly provided a glossary containing the commonly-used terms with respect to Section 404 and AS 2, including those discussed above, to clarify the meaning attached to these terms by the Commission and the PCAOB, to facilitate a common understanding and application of the concepts by both management and auditors, and to ensure consistent use of terminology by all involved parties. Such a glossary would greatly reduce existing confusion and promote successful implementation of and compliance with the rules.

Recognize Other Drivers of Audit Costs

We support the Commission's goal of reducing unnecessary costs and work associated with Section 404, while providing the same benefits and protections to investors. Various studies and surveys support the conclusion that significant reductions in overall Section 404 costs (internal costs as well as external audit fees) have been achieved in the second year of implementation. Providing additional guidance to management on how to perform its assessment can contribute to more effective implementation and may help to further reduce costs. It is important to note that because the largest component of 404 costs continues to be internal issuer costs and third-party out of pocket costs (excluding auditor fees), which together account for approximately 61-67%[3] of total 404 costs, the way management performs its assessment is likely to have the greatest impact on total 404 costs.

As indicated above, the manner in which management completes its assessment, however, directly impacts the work the auditor must do to complete an audit that complies with all applicable professional practice standards. Therefore, while we believe that the Commission can provide valuable guidance to assist management in improving the focus of its assessment process to make it more efficient, and that such guidance may improve the auditor's ability to use the work of management, if management alters the manner in which it completes its assessment such that it is less objective (for example, if management uses a self-assessment process rather than internal audit or a third party to perform its assessment), that may result in a decreased ability of the auditor to use management's work to the extent permitted under AS 2 and cause a corresponding increase in the work the auditor must perform.

We also believe it is important for the SEC to recognize that, although the implementation of AS 2 has been a significant factor in audit costs, there are a number of other significant factors that impact audit costs in general, outside of the Section 404 audit requirements. Other significant factors increasing audit costs include additional audit procedures and documentation requirements based on other new standards, increased demand and intense competition for accounting and auditing resources, increased compliance and regulatory requirements for auditors, practice protection costs, and litigation. We believe it is appropriate for the SEC, in its broader regulatory role, to consider these other factors and their cumulative impact on audit costs, and steps that might be taken to mitigate these factors, without impacting investor protection.

[3] The Sarbanes-Oxley Section 404 Costs and Implementation Issues: Spring 2006 Survey Update by CRA International indicates that issuer costs and third-party costs (excluding auditor attestation fees) comprised 61% of total costs for smaller companies (market capitalization between $75 million and $700 million) and 67% of total costs for larger companies (market capitalization over $700 million). Additionally, results of the March 2006 FEI Survey on SOX Section 404 Implementation indicates that issuer costs and third-party costs (excluding auditor attestation fees) comprised 64% of total 404 costs for accelerated filers during fiscal year 2005.

III. Concept Release Questions

1. ***Would additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting be useful? If so, would additional guidance be useful to all reporting companies subject to the Section 404 requirements or only to a sub-group of companies? What are the potential limitations to developing guidance that can be applied by most or all reporting companies subject to the Section 404 requirements?***

   As discussed above, we strongly believe that additional guidance which describes the Commission's expectations for management in completing an assessment of the effectiveness of internal control over financial reporting would be very useful to management, investors, and auditors. In order for such guidance to have a direct and real impact on management's process, we believe that it should be provided by the Commission. Additionally, because the underlying principles and the overall process of how management completes an internal control assessment (including its decisions regarding scoping, evaluation, and documentation) would be the same, regardless of the size of the company, such guidance should be equally applicable to all companies subject to the Section 404 reporting requirements. Therefore, we do not believe that separate management guidance regarding how to conduct an assessment is needed for smaller companies. However, the guidance provided by the Commission should enable flexibility so that a company of any size can tailor its approach based on the nature and size of the company. Additionally, the Commission may consider providing some examples in its guidance that are focused on smaller businesses.

2. ***Are there special issues applicable to foreign private issuers that the Commission should consider in developing guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting? If so, what are these? Are such considerations applicable to all foreign private issuers or only to a sub-group of these filers?***

   Foreign private issuers (FPIs) have faced some particular challenges relative to the requirements of Section 404. Some of the most challenging aspects for FPIs result from the fact that FPIs prepare their primary financial statements in accordance with local generally accepted accounting principles (GAAP) or in many cases, in accordance with International Financial Reporting Standards (IFRS) and then complete a reconciliation to U.S. GAAP, which is included in the financial statements filed with the Commission.

   Below we describe some specific areas where clarification is needed with respect to FPIs and how we believe these issues can be addressed in the guidance provided by the Commission.

   - Which financial statements should be used to determine the scope of the internal control assessment?

     Differences between local GAAP or IFRS and U.S. GAAP can result in significant differences in the financial statements as well as differences in footnote disclosures. For example, under local GAAP or IFRS, an equity investment might be proportionately consolidated, whereas under U.S. GAAP, the investment might be accounted for under the equity method. Similarly there might be situations where entities are consolidated under U.S. GAAP (e.g., based on the application of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, Revised December 2003) which are not consolidated under local GAAP or IFRS. The SEC staff issued frequently asked questions (FAQs) on management's report on internal control over financial reporting in which question 1 states that the staff "would typically expect management's report on internal control over financial reporting to include controls at all consolidated entities, irrespective of the basis for consolidation."[4]

We believe that the primary financial statements, i.e., those prepared in accordance with local GAAP or IFRS should prevail in terms of determining the scope of the internal control assessment. Such an assessment would nonetheless include the controls over the preparation of the U.S. GAAP reconciliation footnote. Under this approach, entities that are not consolidated under IFRS or local GAAP, would not be required to be included in management's 404 assessment. Similarly, entities that are consolidated or proportionately consolidated under IFRS or local GAAP should be included. This approach is consistent with the guidance in the SEC staff's FAQs (question 1 as discussed above) as well as the guidance in PCAOB AS 2, paragraph B17 which states that "the evaluation of internal control over financial reporting should include controls over significant accounts and processes that exist at the consolidated or proportionately consolidated entity." The exception would be the situation where the issuer does not have the right or authority to assess the internal controls of the consolidated or proportionately consolidated entity and also lacks the ability, in practice, to make that assessment, in which case the related controls could be scoped out in terms of the SEC staff's FAQs (question 1).

- Are FPIs required to consider the evaluation of deficiencies based upon the consideration of the potential misstatement on interim financial statements?

  We believe that the evaluation of deficiencies based upon the consideration of misstatements that could be material to interim financial statements is not applicable to FPIs because they are not required to file reports containing interim financial information with the Commission. FPIs are required to furnish to the Commission any interim financial information that is filed locally. If, however, the FPI chooses to file interim financial statements with the Commission, deficiencies should be evaluated with respect to the impact on both the interim and annual financial statements.

- Are foreign private issuers required to evaluate controls over interim financial reporting?

  We believe that if an FPI does not file interim financial information with the SEC (notwithstanding that such information would be furnished to the SEC if filed with the local regulator), then controls over interim financial reporting would not be included in management's assessment and the FPIs management should disclose in its assessment that such controls have not been included in the assessment. However, if an FPI chooses to file interim financial statements with the Commission, then the controls over such interim financial reporting would be included for purposes of the 404 assessment.

3. Should additional guidance be limited to articulation of broad principles or should it be more detailed?

The Commission's guidance should be articulated in such a way that management has a clear understanding of what is required relative to conducting the assessment of the effectiveness of

[4] See SEC Staff Guidance, *Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports Frequently Asked Questions*, revised October 6, 2004.

internal control over financial reporting. The guidance should also preserve management's flexibility to develop a method to conduct its assessment appropriate to its circumstances.

As discussed further in the answer to question 5, below, the Commission might provide specific guidance and preserve flexibility, by articulating clear principles in the form of a rule and also providing additional, more specific, guidance, including examples, in an interpretive release.

4. ***Are there additional topics, beyond what is addressed in this Concept Release, that the Commission should consider issuing guidance on? If so, what are those topics?***

One area the Concept Release does not address but which is directly related to performing internal control assessments is how the annual assessment of internal control over financial reporting relates to the quarterly certifications under Section 302 about the effectiveness of disclosure controls and procedures, and the nature and extent of evidence required to support management's quarterly certifications. Additional guidance in this area would be beneficial, including additional clarification about the interrelationship between disclosure controls and procedures and internal control over financial reporting and how a conclusion that internal control over financial reporting is ineffective impacts the conclusion about the effectiveness of disclosure controls and procedures (i.e., including the circumstances where management might conclude that disclosure controls and procedures are effective, notwithstanding the existence of one or more material weaknesses in internal control over financial reporting.)

We also believe providing guidance to management and auditors as to the extent of work required when it becomes apparent that a company has a significant number of pervasive material weaknesses would be helpful. For instance, we believe that there may be circumstances under which the number and severity of material weaknesses identified are such that there is no point in management or the auditor continuing to complete the evaluation of internal control over financial reporting, because in such situations appropriate disclosures could be made by both management and the auditor and completing the process would not provide investors with new or useful information. In such situations, we believe the extent and severity of material weaknesses should be disclosed, and the auditor should issue an adverse opinion based on those material weaknesses identified. This suggested approach of issuing an adverse opinion when pervasive material weaknesses exist would necessitate a modification to AS 2 which currently requires the auditor to issue a disclaimer of opinion if an assessment is not completed. However, we believe that such an approach would be appropriate under certain circumstances and, additionally, may reduce cost burdens associated with Section 404 when the conclusion regarding the effectiveness of internal control is readily apparent based on the severity of material weaknesses identified.

5. ***Would additional guidance in the format of a Commission rule be preferable to interpretive guidance? Why or why not?***

As discussed in answer to question 3, we believe that the Commission's objective of providing useful guidance that is scalable and flexible might be best achieved by issuing a rule that is principles-based and a related interpretive release that provides more detailed guidance and examples.

The Commission has taken this approach in other areas, such as Management's Discussion and Analysis of Financial Condition and Results of Operations,[5] where the approach used by a particular company to comply with the Commission's rules might vary greatly from those used by other companies. Such a combination of rules and interpretive guidance can allow the Commission to assist companies in fulfilling the Commission's requirements without the risk of effectively prescribing a process that every company may feel obliged to follow, regardless of the appropriateness to its circumstances.

7. ***Are there potential drawbacks to or other concerns about providing additional guidance that the Commission should consider? If so, what are they? How might those drawbacks or other concerns best be mitigated? Would more detailed Commission guidance hamper future efforts by others in this area?***

We do not believe there are any potential drawbacks of significance to providing management guidance.

8. ***Why have the majority of companies who have completed an assessment, domestic and foreign, selected the COSO framework rather than one of the other frameworks available, such as the Turnbull Report? Is it due to a lack of awareness, knowledge, training, pressure from auditors, or some other reason? Would companies benefit from the development of additional frameworks?***

We believe that most companies have used the COSO framework because it is the only widely recognized U.S.-developed framework. Additionally, the concepts included in the COSO framework are embedded within the auditing standards of the PCAOB and, as such, the concepts and the framework are very familiar to auditors and former auditors, many of whom are now employed as company management. While non-U.S. issuers that have already filed internal control reports have chosen to use COSO, it is not clear whether this trend will continue. There are other alternative frameworks, including CoCo and Turnbull,[6] which are broadly consistent with COSO, and the objectives of internal control over financial reporting under those alternative frameworks are not substantially different from COSO.

Our observation is that the challenges management faces in performing an internal control assessment relate to how to conduct the assessment, and not to the framework used. Specifically management has difficulty determining how to perform a risk assessment, what is in the scope of its assessment, which controls are relevant to achieve the control objectives, and how to gather evidence about the effectiveness of internal control over financial reporting.

We do not believe disagreement exists about the fundamental concepts of internal control over financial reporting (i.e., the framework); however, disagreement and diversity in practice does exist with respect to how extensive a company's internal control structure should be and how management should carry-out its assessment process. Having more frameworks will not solve current issues in the implementation of 404; moreover, the more frameworks that are created, the

[5] See *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations,* Release No. 34-48960 (Dec. 29, 2003).

[6] CoCo stands for *The Criteria of Control Framework* established by the Canadian Institute of Chartered Accountants. The Turnbull Report is the *Internal Control: Guidance for Directors on the Combined Code* issued by the Institute of Chartered Accountants in England and Wales.

less consistency and comparability there will be between issuer's evaluations of the effectiveness of internal control over financial reporting.

9. ***Should the guidance incorporate the May 16, 2005 "Staff Statement on Management's Report on Internal Control Over Financial Reporting"? Should any portions of the May 16, 2005 guidance be modified or eliminated? Are there additional topics that the guidance should address that were not addressed by that statement? For example, are there any topics in the staff's "Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (revised October 6, 2004)" that should be incorporated into any guidance the Commission might issue?***

In order to avoid confusion and any potential minor and unintended inconsistencies between existing guidance and new guidance, new guidance that is developed should incorporate and supersede both the May 16, 2005 *Staff Statement on Management's Report on Internal Control Over Financial Reporting* and the staff's *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions* (revised October 6, 2004).

Additionally, we believe re-emphasizing or clarifying the following concepts contained in the May 16th guidance would be useful:

- The definition of significant accounts. We believe that an account should always be considered significant if it is quantitatively significant. Additionally, if an account is not quantitatively significant, but is affected by qualitative factors that increase the risk of material misstatement, it should also be considered significant. Please refer to question 16 for further discussion.
- The consideration of interim and segment measures in evaluating deficiencies given the current definitions of significant deficiency and material weakness.
- Under what circumstances a restatement may not be considered indicative of a material weakness (for instance, when management had a reasonable basis to conclude the prior accounting was previously correct.) The language included in the May 16th SEC Staff Statement is not entirely consistent with the language in AS 2 and this has created significant confusion and uncertainty. Some view the May 16th Staff Statement to suggest that the restatement of prior financial statements for the correction of an error may not necessarily be indicative of a control deficiency at all, which is inconsistent with paragraph 140 of AS 2 which indicates that a restatement for the correction of an error indicates the existence of at least a significant deficiency, and is a strong indicator of a material weakness. Please refer to question 27 for further discussion of this issue.
- How or whether to use proprietary information technology (IT) frameworks and how to appropriately assess the impact of IT on internal control over financial reporting. Please refer to questions 29 and 30 for further suggestions regarding guidance with respect to IT.

10. ***We also seek input on the appropriate role of outside auditors in connection with the management assessment required by Section 404(a) of Sarbanes-Oxley, and on the manner in which outside auditors provide the attestation required by Section 404(b). Should possible alternatives to the current approach be considered and if so, what? Would these alternatives provide investors with similar benefits without the same level of cost? How would these alternatives work?***

    With respect to the appropriate role of the outside auditor in connection with the management assessment required by Section 404(a), we support a clarification of the language in the current form of the auditor's report on internal control over financial reporting. Currently, AS 2 requires the independent auditor to express separate opinions on (1) whether management's assessment of internal control over financial reporting is fairly stated and (2) whether the company maintained effective internal control over financial reporting.[7] We believe this construct of the auditor's report is confusing to investors, auditors, and management. Many have misunderstood the language in the first part of the opinion to mean that the auditor is providing an opinion on management's assessment process, which is not the case. As explained by Thomas Ray, the PCAOB's Chief Auditor and Director of Professional Standards, "the first of the two opinions expressed by the auditor is not on management's assessment process. Rather, it is the auditor's opinion as to whether management's required statements about the effectiveness of the company's internal control and its descriptions of any material weaknesses are fairly stated."[8]

    We believe the auditor's opinion on whether management's assessment is fairly stated is arguably implicit in the auditor's second opinion. Additionally, in order to opine on whether management's assessment is fairly stated, the auditor must form an opinion on the effectiveness of the controls themselves. As such, the work performed by the auditor is the same regardless of whether an opinion is provided on management's assertion or on internal control over financial reporting itself or both. This concept is embedded in the interim attestation standards adopted by the PCAOB as well as AS 2.[9] Consequently, in order to eliminate the confusion with respect to the auditor's opinion on management's assessment and because such a change will not increase the level of work performed by the auditor, we suggest removing the requirement for the auditor to explicitly express an opinion on whether management's assessment was fairly stated.

    With respect to the manner in which outside auditors provide the attestation required by Section 404(b), we believe that an annual audit of internal control over financial reporting is critical to the effectiveness of Section 404. The potential alternative solutions that have been put forward by some commentators seem to be based on notions that 1) require less frequent audits, 2) limit the scope of the work the auditor performs, or 3) require that the auditor provide an opinion based on

[7] AS 2 paragraphs 167(l) and (m), respectively.

[8] Remarks by Thomas Ray, PCAOB Chief Auditor and Director of Professional Standards, at the 25th Annual SEC and Financial Reporting Institute Conference in Pasadena, California on June 8, 2006.

[9] See PCAOB interim standards, AT 101.51 which sets forth that the auditor is required to obtain sufficient evidence to support the level of assurance provided, regardless of the form of the report (on the subject matter itself or on management's assertion). Also see AS 2, paragraph 19, which states "there is no difference in the level of work performed or assurance obtained by the auditor when expressing an opinion on management's assessment of effectiveness or when expressing an opinion directly on the effectiveness of internal control over financial reporting. In either case, the auditor must obtain sufficient evidence to provide a reasonable basis for his or her opinion and the use and evaluation of management's assessment is inherent in expressing either opinion."

less than reasonable assurance. We believe each of these three alternatives pose problems that would greatly outweigh the benefits.

Alternatives based on less frequent audits of internal control, perhaps every three years or based on a lottery system, would cause confusion in the market place as to the level of auditor assurance provided in any given year and may create a two-class system of reporting companies. In addition, when an audit of internal control is only performed occasionally, or even randomly, the benefits of efficiency and auditor knowledge that can be expected to build up from a yearly integrated audit would be lost. Such approaches also are contrary to the concept of consistently maintaining internal control over financial reporting.

Alternatives based on limiting the scope of the auditor's work, such as reporting only on design and implementation of internal control (i.e., have the controls been properly designed and have they been placed into operation as intended), would not address the most critical question to investors -- are the controls operating effectively as intended?

Alternatives based on the auditor obtaining less than reasonable assurance on which to base the opinion, would likely not result in detecting most material weaknesses. The moderate level of assurance obtained by the auditor when performing a review of interim financial information is based on the auditor performing inquiries and analytical procedures rather than substantive tests. This results in the auditor obtaining only a moderate level of assurance and consequently providing a negative assurance form of report. While the form of report in the context of reviews of interim financial information seems well understood, when attempting to apply the concept of a review to the evaluation of the design and operating effectiveness of internal control over financial reporting, it would be difficult to determine what procedures should be performed other than inquiry since there is no equivalent to analytical procedures in the context of evaluating internal control over financial reporting. For this reason auditing standards have long prohibited reviews of internal control effectiveness. We believe conclusions on the effectiveness of internal control based on less than reasonable assurance (i.e., a high level of assurance) will not be meaningful and will not be understood by users.

11. What guidance is needed to help management implement a "top-down, risk-based" approach to identifying risks to reliable financial reporting and the related internal controls?

Guidance that clearly articulates what it means to use a top-down, risk-based approach to identifying risks to reliable financial reporting and the related internal controls would be extremely helpful to management in completing its assessment process.

We believe that the top-down, risk-based approach to completing an assessment of internal control over financial reporting is a process whereby management:

- Performs a comprehensive risk assessment process;
- Identifies the significant accounts and disclosures and identifies the related relevant assertions (see further discussion regarding the identification of significant accounts in question 16 below);
- Identifies the relevant control objectives related to the significant accounts and disclosures as well as the other components of the internal control framework (e.g., control environment);
- Determines the population of controls that are designed to address the risks of material misstatement, considering all significant accounts and disclosures and relevant assertions

(a control "addresses" the risk of material misstatement when it can be concluded that the risk of material misstatement is remote as a result of the implementation and operation of the appropriately designed control.); and

- In determining this population of relevant controls, management looks first to entity level controls or other controls that address multiple accounts and assertions and disclosures. For each relevant control objective where the risk of material misstatement has not been reduced to remote by entity-level controls, management would then proceed to identify process or transaction-level controls (including automated application controls) at progressively lower-levels within the organization.

The goal of adopting a top-down, risk-based approach to the assessment process is to minimize the number of controls that are included in the scope of management's assessment, to identify those controls that address the greatest number of significant accounts and relevant assertions, and test those controls that provide the rigor and precision necessary to address the risk of material misstatement.

In following a top-down, risk-based approach, however, it is important to be aware that the effectiveness of many controls is dependent upon whether other controls are effectively designed and operating as intended. For instance, controls, including those related to the control environment, general computer controls, and other controls that address the accuracy and integrity of information used in the performance of other controls, will have an impact on other whether other controls are operating effectively.

Frequently rhetoric about the top-down, risk-based approach implies less work will be necessary. While properly applied, use of such an approach will likely reduce work in some areas, however, it may increase work in higher risk areas. Likewise, all entities have risks and many high level controls by themselves do not operate at a level of rigor or precision that is sufficient to address the risk of material misstatement and reduce the likelihood of such risk to more than remote. Accordingly, the Commission's guidance should make these points about limitations of the top-down, risk-based approach.

12. ***Does the existing guidance, which has been used by management of accelerated filers, provide sufficient information regarding the identification of controls that address the risks of material misstatement? Would additional guidance on identifying controls that address these risks be helpful?***

We do not know what existing guidance is being referred to in the above question. In our view guidance on identifying controls that address the risks of material misstatement would be difficult to develop and would be very fact specific. In general, accelerated filers have performed careful analyses of their company specific situations and circumstances in order to identify which controls address the risks of material misstatement. While providing examples in this area may be useful, we do not think it is practical to provide guidance on identifying controls that address the risks of material misstatement.

13. ***In light of the forthcoming COSO guidance for smaller public companies, what additional guidance is necessary on risk assessment or the identification of controls that address the risks?***

The guidance set forth in COSO's *Internal Control – Integrated Framework* as well as the recently released COSO guidance, *Internal Control over Financial Reporting—Guidance for Smaller*

Public Companies, provides the framework under which the risk assessment process might be performed. However, the COSO guidance does not provide a specific "how to" guide for management in performing its assessment. We believe the Commission could set forth in its rule the principles of conducting a risk assessment (based on the COSO framework) and include some specific "how-to" guidance in an interpretive release for management to follow. This "how-to" guidance should specifically address management's fraud risk assessment as well as assessing pervasive risk factors at the company level.

14. In areas where companies identified significant start-up efforts in the first year (e.g., documentation of the design of controls and remediation of deficiencies) will the COSO guidance for smaller public companies adequately assist companies that have not yet complied with Section 404 to efficiently and effectively conduct a risk assessment and identify controls that address the risks? Are there areas that have not yet been addressed or need further emphasis?

We believe the COSO guidance for smaller public companies will be helpful to companies that have not yet completed a 404 assessment. Additionally, overall, it will improve understanding of the COSO framework and how to implement it.

With respect to management's risk assessment process, although the COSO guidance does not specifically tell management how to conduct a risk assessment, we believe the guidance does provide sufficient information to management in order to develop such a process. The risk assessment process followed by management is critical to the 404 assessment process and following a risk-based approach. If companies diligently identify the risks of material misstatement of the financial statements and the related relevant controls at the front end of the assessment process, it will ensure that management's process is efficient and effective and will avoid unnecessary documentation efforts.

With respect to identifying controls that address the risks, please refer to our answer to question 12.

With respect to management's documentation, management has often used paragraphs 42-44 in AS 2 as a guideline for purposes of documenting the design of controls and its assessment. We believe that the elements outlined in paragraph 42 are appropriate for management's documentation and that the guidance in AS 2 paragraph 42 should be written in the context of management's requirements and included in guidance issued by the Commission.

Assessing the design-effectiveness of controls is a complex process. It requires management to assess the risks of material misstatement (both pervasive risks and risks specific to account balances and assertions or financial statement disclosures), identify controls that address the risks, and match the controls to risks, among other activities. In order to accomplish such an assessment, management will need to create some sort of documentation that demonstrates its process, as the entire process simply can not take place in the minds of management.

In addition to documenting the design of internal control over financial reporting, management needs to have evidence supporting its testing of the operating effectiveness of such controls. Guidance provided by the Commission in this area should be consistent with the requirements placed on the auditor with respect to documentation that the auditor is required to maintain as evidence of the work that the auditor has performed. There is a risk that if management's documentation requirements do not align with the auditor's requirements, then the auditor may not be able to use the work of management to the extent permitted under AS 2. See further discussion regarding management's documentation in the answer to question 31.

15. ***What guidance is needed about the role of entity-level controls in evaluating and assessing the effectiveness of internal control over financial reporting? What specific entity-level control issues should be addressed (e.g., GAAP expertise, the role of the audit committee, using entity-level controls rather than low-level account and transactional controls)? Should these issues be addressed differently for larger companies and smaller companies?***

With respect to entity-level controls, we believe guidance that addresses the characteristics of entity-level controls and how they impact the nature, timing, and extent of management's assessment process would be very helpful. Additionally, as discussed in our overall comments, we believe significant confusion exists as to whether the terms entity-level controls and company-level controls (which is the term used in AS 2) refer to the same types of controls and how such controls differ from process-level controls.

In our view, guidance provided by the Commission with respect to entity-level controls, should explain that some entity-level controls operate at the "company-level" and do not directly address risks that significant accounts and assertions might be materially misstated, whereas other entity-level controls (such as detective monitoring controls designed at a sufficiently precise level to detect material misstatements) may operate at the "account or assertion level" and address specific risks associated with significant accounts, relevant assertions and financial statement disclosures.

Because many entity-level controls are not designed to directly address the risks and relevant assertions associated with significant accounts and disclosures, we do not believe that assessing only entity-level controls is sufficient. An internal control assessment, by definition, would need to include the evaluation of relevant process or transactional level controls that relate to significant accounts and relevant assertions not otherwise addressed. For example, if a company has an effective tone at the top or an effective audit committee this would not eliminate the need for management to evaluate the effectiveness of relevant controls over revenue recognition. However, the strength of entity-level controls such as the tone at the top may impact *the nature, timing and extent* of management's evaluation of process or transactional level controls. For example, a company with weak tone at the top and lacking effective monitoring of controls may need to perform a more rigorous evaluation of controls at the process or transactional level.

In performing a top-down, risk-based assessment, the most efficient method of setting the population of controls to test is to include within the scope of management's assessment those entity-level controls that specifically address relevant assertions associated with significant account balances and disclosures. For example, certain detective monitoring controls such as financial analysis and other operational metrics may be designed at a specific level of precision to address specific assertions related to significant account balances and disclosures (i.e., a financial analysis that is designed to identify and investigate variances over a certain threshold, setting the threshold at an amount that would be material to the financial statements keeping in mind aggregation issues.) However, reliance on these detective monitoring controls may not be sufficient if they are 1) dependent upon the effectiveness of the underlying controls to produce reliable information to analyze or 2) do not address all significant accounts and relevant assertions (as discussed above).

We believe that entity-level controls operate in the same manner, regardless of the size of the company, and, for all companies, the challenge is determining the extent to which entity-level controls are designed at an appropriate level of precision to address the relevant assertions of the significant accounts.

We recommend that the Commission's guidance clearly illustrate the above concepts.

16. Should guidance be given about the appropriateness of and extent to which quantitative and qualitative factors, such as likelihood of an error, should be used when assessing risks and identifying controls for the entity? If so, what factors should be addressed in the guidance? If so, how should that guidance reflect the special characteristics and needs of smaller public companies?

To support its assertion with respect to the effectiveness of internal control, management needs to consider and evaluate the controls identified to address the financial reporting risks related to all significant accounts and disclosures. Guidance with respect to how management identifies significant accounts and disclosures that impact financial reporting, including the use of quantitative and qualitative factors, would be extremely helpful in assisting management in determining the scope of its assessment.

Any guidance provided by the Commission should clarify that an account is significant if it is reasonably possible or probable[10] that the account could contain misstatements that individually, or when aggregated with others, could have a material effect on the financial statements, considering the risks of both overstatement and understatement. The concept of "reasonably possible or probable" needs to be evaluated based on the inherent risk of material misstatement existing or occurring within the account, without consideration of whether or not controls are in place to prevent or detect such misstatement. This description of a significant account is consistent with AS 2.[11]

Using this concept to assess whether or not an account is significant, management should evaluate both the magnitude of the account and the likelihood of a material misstatement existing in the account. In evaluating both magnitude of an account and likelihood of potential error, it is difficult to conclude that an account that is quantitatively material to the annual or interim financial statements has a *remote* likelihood of a material misstatement. As such, we believe the guidance should specify that if an account is quantitatively significant (i.e., material to the annual or interim financial statements) then the account should ordinarily be considered a significant account.[12] Additionally, any guidance should clarify that if an account is not quantitatively significant, there may be qualitative characteristics that would otherwise cause management to consider the account to be significant (e.g., related party transactions, accounts with high susceptibility to errors that

[10] The PCAOB has clarified that "more than a remote likelihood" means "reasonably possible or probable". See AS 2 paragraph 9.

[11] AS 2 paragraphs 60-67.

[12] If such an approach is not adopted, accounts such bank deposits for a financial institution (an account often argued to have a remote likelihood of misstatement) might be considered out of management's 404 scope, even though such an account typically comprises an overwhelming majority of the balance sheet for financial institutions. The suggested approach outlined, would consider bank deposits to be a significant account and the controls addressing the control objectives related to the relevant assertions would be included in management's 404 assessment, but would allow for varying the nature, timing, and extent of testing based on the level of risk associated with the account.

might be material to the financial statements due to inherent risks and complexities). However, the guidance should recognize that although an account may be considered to be significant, the nature, timing and extent of management's process to evaluate the effectiveness of controls would ordinarily vary based on the qualitative factors that impact the level of risk associated with the account and relevant assertions.

For example, consider the fixed asset account of a company when the recorded amount is a large balance but there is a low volume of transactions and the inherent risk of material misstatement might be assessed as low. If the balance is material to the financial statements, management should consider the fixed asset account to be significant. However, due to the relatively low (although more than remote) risk of material misstatement of the fixed asset account, management may identify fewer relevant controls addressing the relevant assertions for fixed assets and may perform a less rigorous evaluation of those controls when compared to other account balances and assertions that are quantitatively larger or qualitatively more complex and where the accounting requires the exercise of more judgment (e.g., revenue accounts in a company where the revenue recognition issues are more complex). For instance, management might determine that relying on the specific financial analysis that is performed by management and used to monitor fixed asset activities is sufficient to assess the controls addressing the relevant assertions for fixed assets rather than performing tests of the specific process-level controls over fixed assets. Such financial analysis might include developing unbiased expectations regarding fixed asset additions and depreciation expense, comparing actual additions and depreciation expense to developed expectations, and evaluating any differences over a determined threshold (set at an amount that will detect misstatements that are material to the financial statements, taking into account the possible aggregation of misstatements). The analysis would also need to include certain procedures to determine that the information used to complete the analysis is accurate and complete. An analysis also might include understanding certain fluctuations in account activity when comparing certain balances and ratios such as:

- comparing actual capital expenditures in the current year to budgeted capital expenditures in the current year;
- comparing actual capital expenditures in the current year to actual capital expenditures in the prior year; and
- comparing depreciation expense to total fixed assets in the current year and comparing the current year ratio of depreciation expense to total fixed assets to the same prior year ratio.

Regardless of the size of the company, the general types of quantitative and qualitative factors considered should be the same. As a result, in determining the scope of management's assessment, we do not believe that guidance regarding "special characteristics and needs of smaller public companies" is necessary.

17. ***Should the Commission provide management with guidance about fraud controls? If so, what type of guidance? Is there existing private sector guidance that companies have found useful in this area? For example, have companies found the 2002 guidance issued by the AICPA Fraud Task Force entitled "Management Antifraud Programs and Controls" useful in assessing these risks and controls?***

Although certain entity-level controls are specifically focused on fraud prevention and detection, we believe the purpose of all internal controls is to prevent and detect fraud. Therefore, the Commission's guidance should encourage management to use available resources to design an effective internal control system on an overall basis, which by definition will include antifraud controls and a fraud risk assessment process. It may be helpful for the Commission to provide a list of such resources that are currently available including the guidance issued by the AICPA Fraud Task Force, "Management Antifraud Programs and Controls" as well as factors outlined under the Federal Sentencing Guidelines regarding an effective program to prevent and detect violations of law.[13]

Generally, we believe management's fraud risk assessment should include the following steps: 1) evaluation of fraud risk factors with assistance from various levels within the organization; 2) identification of possible fraud schemes and scenarios through a brainstorming session, with special consideration given to the risk of management override of controls; and 3) an evaluation of whether mitigating controls exist or are effective.

18. Should guidance be issued to help companies with multiple locations or business units to understand how those affect their risk assessment and control identification activities? How are companies currently determining which locations or units to test?

We believe that guidance to assist management in determining the nature and extent of procedures required to assess the effectiveness of controls in a multi-location environment would be helpful.

We believe that the guidance should first clarify that a company's management (regardless of whether it has multiple locations) has a responsibility to evaluate the design and operating effectiveness of controls that address all relevant financial statement assertions related to all significant accounts, including those at remote locations. In a multi-location environment, this simply means that for each location that has accounts which, when aggregated with similar accounts at other locations, are significant to the consolidated entity, management's process to assess the effectiveness of internal control over financial reporting should include the evaluation of the effectiveness of controls at such a location. It should be expected that management's process would cover substantially all locations. However, the nature, timing and extent of procedures performed at various locations will vary as described below.

The Commission's guidance should acknowledge that management is afforded a wide range of options to gather evidence regarding the effectiveness of internal controls. Generally, we would expect that in a multi-location environment, management would use a combination of ongoing monitoring (e.g., regular management and supervisory activities), self assessment, and independent testing by management, internal auditors or others to obtain evidence related to the effectiveness of controls upon which to base its assessment. We believe strongly that the guidance should also address the fact that the nature and extent of the procedures to evaluate the effectiveness of controls in multiple location environment will vary depending on the individual importance of the location to the entity as a whole and the nature of the various significant accounts and disclosures. Individual importance would be determined based on characteristics such as financial significance of the location to the entity as a whole and/or the risk of misstatement arising from the entity. It is logical to expect that as the individual importance of the location and the risks associated with related account balances and disclosures increases, that the level of evidence that management requires relative to the design and operating effectiveness of internal controls at that location would be more extensive.

[13] See 2002 Federal Sentencing Guidelines, Section 8A1.2 Application Notes.

The guidance should also address the fact that effectiveness of entity-level controls may significantly impact management's assessment process in a multi-location environment. For example, if management has effective entity-level controls including strong tone at the top, effective risk assessment, and an effective self assessment program at each location, the number of locations that internal audit would be expected to visit in order to support management's annual assessment of the effectiveness of internal control would be fewer than if, for example, an entity did not have a strong control environment, or if its risk assessment process was weak, or if no self assessment program existed.

19. ***What type of guidance would help explain how entity-level controls can reduce or eliminate the need for testing at the individual account or transaction level? If applicable, please provide specific examples of types of entity-level controls that have been useful in reducing testing elsewhere.***

As discussed in question 15, some entity-level controls operate at the "company-level" (i.e., controls related to the control environment) and do not directly address risks associated with significant accounts and relevant assertions, whereas other entity-level controls (such as specific financial analysis used as a detective monitoring control) may operate at the "account or assertion level" and address risks associated with significant accounts and relevant assertions.

Entity-level controls that do not directly address the relevant assertions related to the significant accounts and disclosures can not eliminate the need to evaluate and test the controls that do address the relevant assertions related to significant accounts and disclosures. Management's objective in performing an assessment is to evaluate controls that address all relevant assertions related to all significant accounts and disclosures. Not all relevant assertions related to all significant accounts will be addressed by entity-level controls. As such, management will need to consider control activities at the process-level in order to perform its internal control assessment.

However, as discussed in the answer to question 15, the strength of entity-level controls may impact the nature, timing, and extent of testing of other process-level controls. For example, certain monitoring controls such as financial analysis and other operational metrics may be designed at a specific level of precision to address specific assertions related to significant account balances and disclosures (i.e., a financial analysis that is designed to identify and investigate variances over a certain threshold, setting the threshold at an amount that would be material to the financial statements keeping in mind aggregation issues.) However, reliance on these detective monitoring controls alone is generally not sufficient as they are 1) dependent upon the effectiveness of the underlying controls to produce reliable information to analyze and 2) unlikely to address all relevant assertions related to all significant accounts and disclosures (as discussed above).

20. ***Would guidance on how management's assessment can be based on evidence other than that derived from separate evaluation-type testing of controls, such as on-going monitoring activities, be useful? What are some of the sources of evidence that companies find most useful in ongoing monitoring of control effectiveness? Would guidance be useful about how management's daily interaction with controls can be used to support its assessment?***

Yes, guidance regarding how management's assessment can be based on evidence other than that derived from separate evaluations would be useful.

Under the COSO Framework, management can evaluate internal control through a combination of on-going monitoring activities and separate evaluations. Significant confusion has arisen on the part of management around the use of these terms, how to use on-going monitoring and separate evaluations effectively, and what evidence is needed under either scenario to provide sufficient evidence of operating effectiveness of controls.

We suggest that the Commission clarify in its guidance that in order to be an effective source of evidence, on-going monitoring activities (e.g., regular management oversight or supervisory activities) should be supported by the following:

- evidence of what the on-going monitoring activities are;
- evidence that there is a process for communicating findings (regardless of whether there are exceptions identified); and
- evidence of how exceptions, when identified, are evaluated and resolved.

Additionally, it would be very helpful if the guidance provided examples of effective monitoring controls.

21. ***What considerations are appropriate to ensure that the guidance is responsive to the special characteristics of entity-level controls and management at smaller public companies? What type of guidance would be useful to small public companies with regard to those areas?***

As discussed in the answers to questions 15 and 19, entity-level controls may be used to reduce the need for testing at the individual account or transaction level if they address (at the appropriate level of rigor and precision) the relevant assertions of significant accounts. This is true regardless of the size of the company. As such, guidance regarding use of entity-level controls would apply equally to both large and small companies. In a smaller company, it might be the case that entity-level controls (e.g., daily monitoring of sales, weekly monitoring of cash) are effectively designed to address specific assertions related to significant accounts at a sufficient level of rigor or precision such that management might be able to conclude that the risk of material misstatement of the applicable account is more than remote. However, the same could be true at a large company, provided that the control was appropriately designed to be sufficiently precise.

22. ***In situations where management determines that separate evaluation-type testing is necessary, what type of additional guidance to assist management in varying the nature and extent of the evaluation procedures supporting its assessment would be helpful? Would guidance be useful on how risk, materiality, attributes of the controls themselves, and other factors play a role in the judgments about when to use separate evaluations versus relying on ongoing monitoring activities?***

Guidance regarding the use of separate evaluation-type testing (e.g., independent testing by internal audit or management and self assessments) would be useful. This guidance should reflect the fact that management should base the nature and extent of the evaluation procedures on factors such as the following:

- The potential for management override of the controls;
- The pervasiveness of the control;
- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement;

- The degree of judgment required to evaluate the operating effectiveness of the control; and
- The level of judgment or estimation required in the account or disclosure.

As the presence of the factors above increase with respect to an individual control activity, it would be reasonable to expect the extent of the separate evaluation procedures to increase (e.g., independent testing by internal audit or others in combination with self assessment).

Additionally, we believe that any guidance with respect to separate evaluation-type testing should reflect the fact that as the frequency of the control activity increases it would be reasonable to expect that the extent of testing would increase proportionally. For example, a sample size of 2 might be appropriate when performing a separate evaluation of the effectiveness of a control activity that operates monthly, whereas a control activity that operates many times per day might require a sample size of 25 in order to conclude on the effectiveness of the control activity.

23. ***Would guidance be useful on the timing of management testing of controls and the need to update evidence and conclusions from prior testing to the assessment "as of" date?***

We believe that guidance related to the requirement for management to update conclusions reached at an interim date to the "as of" date of the assessment would be useful. Any such guidance should recognize that to the extent management has tested controls prior to the "as of" date, management should update or "roll forward" the conclusions on the effectiveness of the design and operating effectiveness of all relevant controls to the "as of" date of management's assessment. The guidance should recognize that management is afforded various means by which they may obtain the evidence necessary to roll forward their conclusions, including but not limited to the consideration of monitoring processes (e.g., regular management and supervisory activities), updating a self-assessment process and/or performing independent tests. Any guidance should also recognize that the nature and extent of such roll forward procedures performed by management will likely vary depending on various factors such as the following:

- The overall effectiveness of the control environment;
- The specific controls tested prior to the "as of" date and the results of those tests;
- The significance of the assessed risk of material misstatement associated with the account balance and assertion or financial statement disclosure that is addressed by the control activity;
- The degree to which evidence of the operating effectiveness was obtained at the interim date (i.e., the less reliable or conclusive the evidence is at the interim date, the more extensive the roll forward procedures);
- The length of the remaining period (i.e., the longer the remaining period, the more extensive the roll forward procedures); and
- If there have been any significant changes in internal control over financial reporting subsequent to the interim date.

24. ***What type of guidance would be appropriate regarding the evaluation of identified internal control deficiencies? Are there particular issues in evaluating deficient controls that have only an indirect relationship to a specific financial statement account or disclosure? If so, what are some of the key considerations currently being used when evaluating the control deficiency?***

Guidance from the Commission should clearly articulate that management and auditors should evaluate internal control deficiencies in the same manner using the same principles. AS 2 provides the principles under which the auditor evaluates internal control deficiencies. We agree with these principles for evaluating deficiencies and believe management should follow the same principles, including the guidance regarding strong indicators of a material weakness. These principles require that deficiencies be evaluated based on a) the likelihood of a misstatement and b) the potential magnitude of the misstatement. Control deficiencies that have only an indirect relationship to a specific financial statement account or disclosure (for example, deficiencies with respect to the control environment) generally do not directly result in a misstatement of the financial statements. Therefore, it is not possible to quantify the effects of some types of deficiencies. Accordingly, evaluations of deficiencies that are indirectly related to financial statement accounts and disclosures are based on the likelihood that the deficiency could contribute to circumstances that could result in a misstatement. The key considerations that are used currently to evaluate such deficiencies are those included in AS 2 as well as the *Framework for Evaluating Control Exceptions and Deficiencies* which is based on and consistent with the guidance in AS 2.[14]

25. Would guidance be helpful regarding the definitions of the terms "material weakness" and "significant deficiency"? If so, please explain any issues that should be addressed in the guidance.

We agree with the definitions of significant deficiency and material weakness. At this point in the implementation and learning curve of 404, we would be reluctant to modifying the definitions as any change could likely result in additional confusion about the required scope of management's assessment as well as how to evaluate deficiencies.

However, if the Commission is concerned that the current definitions are driving a level of work that was not intended, we would recommend removing the word "interim" from the definitions of significant deficiency and material weakness. Removing "interim" would make it clear that the scope of management's assessment should be based on an annual materiality level (although both the SEC and the PCAOB have explained that the concept of interim materiality should only be used in evaluating deficiencies and not in determining the scope of the assessment or audit, it is possible that some confusion still remains, especially for those who have yet to implement 404.) This modification, however, would also result in a change in how deficiencies are evaluated; if the word "interim" is removed, deficiencies would not be evaluated in light of what is material to both interim and annual periods, but only to annual periods.

A separate suggestion that has been made with respect to the definitions is the suggestion of removing the reference to "significant" deficiency from the definition of material weakness and simply referring to deficiencies. However, we are concerned that such a change will actually drive more work and not less. If the concern is that the reference to "significant deficiency" in the definition of material weakness has driven companies to search for significant deficiencies, changing the language to refer to "deficiencies" might actually drive even more work, as there would be a larger universe of deficiencies to consider in the aggregate. We would caution against making such a change.[15]

[14] *A Framework for Evaluating Control Exceptions and Deficiencies*, Version 3 (December 20, 2004) was developed by representatives of BDO Siedman, Crowe Chizek and Company LLC, Deloitte & Touche LLP, Ernst & Young LLP, Grant Thornton LLP, Harbinger PLC, KPMG LLP, McGladrey & Pullen LLP, and PricewaterhouseCoopers LLP. William F. Messier, Jr., Professor, Georgia State University also contributed to the development of this framework.

[15] The definition of a material weakness is a "significant deficiency or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial

Although we would be reluctant to change the current definitions, additional guidance regarding the application of the definitions would be helpful. For instance, guidance is particularly needed with respect to the following areas:

- Evaluating restatements that result from misinterpretations of GAAP when the company had a reasonable basis for their original position, but later regulators or others interpret or re-interpret the accounting, and arrive at a different answer causing the need for a restatement of the prior financial statements for the correction of an error. This could include instances when a company might have believed that several accounting alternatives were acceptable and had gone through an appropriate process to select one for use by the company and where regulators or others subsequently conclude that only a single preferable alternative should have been followed. See further discussion of this issue in the answer to question 27 below.
- Interpreting the "could" factor in evaluating the potential magnitude of a misstatement. We agree with the concept that the evaluation of deficiencies needs to consider the magnitude and likelihood of a potential misstatement that might occur, and not just the actual misstatement that did occur. However, additional guidance and examples for different types of deficiencies should be provided to reduce the uncertainty and inconsistency in practice as to the quantification of a misstatement that "could" result.

26. Would guidance be useful on factors that management should consider in determining whether management could conclude that no material weakness in internal control over financial reporting exists despite the discovery of a need to correct a financial statement error as part of the financial statement close process? If so, please explain.

We believe that guidance for evaluating the impact of financial statement errors detected during the financial statement closing process would be useful. However, we believe that errors detected in the financial statement close process need to be differentiated between those errors detected by management and those errors detected by the external auditor for purposes of considering their impact on conclusions related to the effectiveness of internal control over financial reporting.

First, we believe that if management discovers an error in the financial statement close process, then it is evidence that there are controls in place and working at least at level of precision necessary to detect the error in question. We do however believe that management should consider errors detected during the financial statement close process in light of how their internal controls were designed to operate (e.g., was the error detected by the control designed to detect such error or was there a control breakdown somewhere in the process). If there were controls that failed to operate effectively or were not adequately designed then management should evaluate these deficiencies to determine whether or not a material weakness exists individually or when aggregated with other deficiencies.

Secondly, with respect to errors discovered by the external auditor in the financial statement close process, we believe that any guidance issued should outline factors to be considered when evaluating the impact of such errors on conclusions related to the effectiveness of internal control over financial reporting (e.g., were management's control processes complete, did all relevant controls have the opportunity to operate). Any guidance should clearly articulate the fact that the

statements will not be prevented or detected" (paragraph 10) If "significant deficiency" is replaced with "deficiency" this might be interpreted by management as requiring more work (i.e., it could be misconstrued to mean there is a need to look for all deficiencies).

results of auditing procedures cannot be considered when evaluating whether the company's internal control provides reasonable assurance that the company's financial statements will be presented fairly in accordance with GAAP (i.e., management can not rely on the auditor's work); that timely communication between management and the auditor on the application of accounting standards and matters related to internal control is permitted and encouraged; and that management has flexibility to provide the auditor with draft financial statements for review with the caveat that they are considered "draft" and that management has not completed its process.

However, we also believe that if the auditor detects a material error in the financial statement close process and management concludes that this fact is not the result of a material weakness, management should be required to identify what control(s) had not yet operated when the auditor detected the material error. Additionally, there would need to be evidence that such controls were designed and implemented at the "as of" date such that there is more than a remote probability that they would have identified the error had they operated prior to the auditor detecting the error.

27. Would guidance be useful in addressing the circumstances under which a restatement of previously reported financial information would not lead to the conclusion that a material weakness exists in the company's internal control over financial reporting?

Yes, we believe that guidance in this area would be useful. As discussed in our answer to question 9, the language included in the May 16, 2005 SEC Staff Statement is not entirely consistent with the language in AS 2 and this has created significant confusion and uncertainty. Some view the May 16th Staff Statement to suggest that the restatement of prior financial statements for the correction of an error may not necessarily be indicative of a control deficiency at all. This interpretation is inconsistent with paragraph 140 of AS 2 which indicates that a restatement for the correction of an error indicates the existence of *at least* a significant deficiency, and a strong indicator of a material weakness.[16]

We believe that there may be very limited circumstances where management and the auditor might conclude that the restatement of prior financial statements for the correction of an error is not indicative of a material weakness, and in these very limited circumstances there may be no control deficiency at all. We do recognize that this is inconsistent with AS 2 as currently written. The following is illustrative of what we believe these specific limited circumstances might be:

Example: Management went through an appropriate process to develop a reasonable basis for the company's original position on how to account for a transaction or situation involving a complex accounting issue for which the accounting literature does not provide specific guidance. The company developed and maintained contemporaneous evidence supporting its position (e.g., a detailed memorandum that describes the facts, the applicable accounting literature that was considered, and the basis for management's conclusion as to the appropriateness of the applied accounting principles). The external auditor agreed that management had a reasonable basis for its original position. Subsequently, for example through the SEC staff review process, the original accounting is challenged, it is determined that an alternative accounting treatment would be more appropriate, and therefore a restatement of the previous financial statements is necessary. In this situation, one could argue, despite the restatement, that there is no underlying control deficiency at all (i.e., no design or operating effectiveness deficiency for the company to remediate).

[16] Also see discussion in AS 2 paragraph E99.

We recommend that the Commission clearly articulate in its guidance the very specific limited circumstances when a restatement of prior financial statements for the correction of an error may not be indicative of a material weakness and whether in such situations a control deficiency may not exist at all. If the Commission agrees that the above example is illustrative of the only specific limited circumstances in which a restatement of prior financial statements may not be indicative of a control deficiency at all, we recommend that the Commission illustrate this point using the above example (or a similar example) and that paragraph 140 of AS 2 be modified accordingly. Also, if there are additional situations in which the Commission believes a restatement of prior financial statements for the correction of an error may not be indicative of a material weakness, we recommend that the Commission articulate what those additional specific situations are.

28. How have companies been able to use technology to gain efficiency in evaluating the effectiveness of internal controls (e.g., by automating the effectiveness testing of automated controls or through benchmarking strategies)?

Controls automation and monitoring is gaining traction with companies as a vehicle to increase the effectiveness of internal control over financial reporting, to reduce risk, and to reduce compliance costs. Technology and tools can be utilized by companies for continuous monitoring related to segregation of duties, transaction monitoring and analysis, and process control monitoring. A number of commercial vendors provide these tools for purposes of continuous monitoring. These vendors are investing significant amounts into creating additional tools for purposes of testing automated controls. The use of available continuous monitoring tools applied in support of a company's compliance environment can improve the efficiency and effectiveness of internal control over financial reporting, as well as the efficiency and effectiveness of testing of those controls.

If a company has effective controls within IT, the more those companies can establish effective automated controls and rely on them to address relevant risks associated with financial reporting, the more efficient management's assertion process will be. Well-established automated controls are less prone to error or manipulation or other potential performance problems that are associated with manual controls.

29. Is guidance needed to help companies determine which IT general controls should be tested? How are companies determining which IT general controls could impact IT application controls directly related to the preparation of financial statements?

IT general controls or general computer controls can potentially affect all relevant assertions for significant account balances and disclosures affected by application systems that are subject to the processing environments to which those general computer controls relate. As such, general computer controls are integral to internal control over financial reporting in any environment where information technology creates financial data used in the preparation of the financial statements or to where automated application controls are relevant to addressing the risks that significant accounts and disclosures might be materially misstated. Despite the importance of general computer controls and application controls, some companies find it challenging to identify those automated controls that should be scoped into their internal control assessment process.

We believe general guidance is needed to help companies determine the relevant objectives of IT controls and which IT general controls and application controls should be scoped into their assessment and tested. However, we do not believe that the guidance should be prescriptive in nature or that an exact checklist of the general computer controls and application controls to be tested can or should be provided, because each company's IT environment is unique. Rather, management should, based on its risk assessment process, identify the relevant controls based on the company's control objectives and determine, based on the facts and circumstances, which controls meet or contribute to meeting those objectives (including IT general and application controls) and such controls should be scoped into the internal control assessment.

30. Has management generally been utilizing proprietary IT frameworks as a guide in conducting the IT portion of their assessments? If so, which frameworks? Which components of those frameworks have been particularly useful? Which components of those frameworks go beyond the objectives of reliable financial reporting?

Based on our experiences, we believe about 60-70% of companies are using IT frameworks to guide their IT assessment activities. They have used these frameworks as a means to help plan and execute IT documentation and testing procedures in support of Section 404 compliance. Companies not using such frameworks have either developed their own approach and/or leveraged guidance provided by others.

In understanding the benefits of various IT frameworks, it is important to note that many companies, generally speaking, have struggled with conducting the IT portion of their assessments of internal control. For instance, many companies struggled to understand what was required relative to IT controls, and in particular with the issue of identifying which IT controls are indeed relevant to financial reporting. They also struggled in applying a risk-based approach for IT, and as a result, spent time documenting and testing controls in areas of lesser risk. Overall, many companies have tended to document and test IT general controls without a good understanding of how their computer processing environments and the related IT general controls impact the financial reporting process and the associated risks. Therefore, in assessing the usefulness of IT frameworks for Section 404, the Commission should consider how these frameworks help companies identify relevant controls.

There are several frameworks in use, including guidance provided by the Information Systems Audit and Control Association (ISACA), the International Standards Organization Security Management Framework (ISO17799), and the IT Infrastructure Library (ITIL). We have found that many companies are using ISACA's document entitled, "IT Control Objectives for Sarbanes-Oxley", which is based on ISACA's COBIT framework (Control Objectives for Information and related Technology). Below is a brief description of each of these frameworks. Despite the existence of these frameworks, as discussed in our answer to question 29, we believe general guidance is needed to help companies determine the relevant objectives of IT controls and which IT general controls and application controls should be scoped into their assessment and tested.

ISACA - IT Control Objectives for Sarbanes-Oxley

According to ISACA, this publication is in use at more than 70% of public companies and has been downloaded more than 700,000 times. From our experience, it is clearly the most common IT control framework in use. This publication suggests specific controls that may be relevant from a financial reporting perspective as well as providing some narrative on the approach to identifying relevant controls. More recently, ISACA has endeavored to update this publication to reflect new guidance published by the SEC and PCAOB as well as to reflect best practices and lessons learned from the initial years of compliance.

In developing the publication, ISACA sought input from industry and the profession to narrow its scope to those controls relevant to financial reporting. The most recent version of the publication highlights the relevant controls that it believes are required for financial reporting, but is clear to state that there is "no one size fits all" and that companies need to go through a process of risk assessment before controls can be properly designed and considered sufficient and appropriate.

ITIL

The IT Infrastructure Library is an IT process management framework, rather than an IT control framework. As such, ITIL is primarily concerned with the effective and efficient design of IT processes rather than controls within processes. For instance, ITIL does not provide guidance that addresses the risk of unauthorized access within systems and what controls can be implemented to reduce this risk. ITIL is gaining popularity as a complement to Sarbanes-Oxley initiatives as companies seek to enhance their overall IT governance rather than just comply with the Section 404 Sarbanes-Oxley requirements. However, on its own, ITIL may not provide a suitable basis for guiding companies towards performing a Section 404 assessment.

ISO17799

Similar to ISACA's COBIT framework, the ISO17799 security framework has been in use for several years, and provides a sound basis for designing controls to establish the security and availability of information technology. Many companies are using this framework and significant research and best practice information has been developed around it. This framework is intended to address both operational and financial objectives, but to date, we are unaware of any efforts to customize it specifically for financial reporting. As a result, many of the controls embedded within the framework, such as business continuity, asset classification and others are not relevant to financial reporting and would exceed what would ordinarily be required for Section 404 compliance.

31. Were the levels of documentation performed by management in the initial years of completing the assessment beyond what was needed to identify controls for testing? If so, why (e.g., business reasons, auditor required, or unsure about "key" controls)? Would specific guidance help companies avoid this issue in the future? If so, what factors should be considered?

As discussed in our answer to question 14, management has used paragraphs 42-44 in AS 2 as a guideline for purposes of documenting internal control. These paragraphs provide the guidance under which the auditor is required to evaluate management's documentation. Because AS 2 was approved by the Commission, it is assumed that the Commission agrees with these tenants of management documentation. Paragraph 42 of AS 2 requires the auditor to evaluate whether management's documentation includes the following:

- The design of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. The documentation should include the five components of internal control over financial reporting, including the control environment and company-level controls.
- Information about how significant transactions are initiated, authorized, recorded, processed, and reported.
- Sufficient information about the flow of transactions to identify the points at which material misstatements due to error or fraud could occur.

- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties.
- Controls over the period-end financial reporting process.
- Controls over safeguarding of assets.
- The results of management's testing and evaluation.

We believe that the elements outlined above should be present in management's documentation, and guidance issued by the Commission should be consistent with the above.

Additionally, such guidance should specifically address documentation of separate evaluations and monitoring. For instance, the guidance could provide that:

- The documentation of separate evaluations should be sufficient to enable someone who is not involved in the design or performance of the control to understand the nature, timing, extent and results of procedures performed.
- Documentation of on-going monitoring activities should include:
    - Documentation of the on-going monitoring activity;
    - Evidence that there is a process for communicating findings (regardless of whether there are exceptions identified); and
    - Evidence of how exceptions, when identified, are evaluated and resolved.

Overall, management needs to have a basis for its internal control assessment in the form of evidential matter, and this basis should be documented. We believe that having no documentation would not comprise sufficient evidential matter.

32. ***What guidance is needed about the form, nature, and extent of documentation that management must maintain as evidence for its assessment of risks to financial reporting and control identification? Are there certain factors to consider in making judgments about the nature and extent of documentation (e.g., entity factors, process, or account complexity factors)? If so, what are they?***

See answer to question 31.

33. ***What guidance is needed about the extent of documentation that management must maintain about its evaluation procedures that support its annual assessment of internal control over financial reporting?***

See answer to question 31.

34. ***Is guidance needed about documentation for information technology controls? If so, is guidance needed for both documentation of the controls and documentation of the testing for the assessment.***

The principles of management documentation should be the same across all controls. As such, the principles for documenting information technology controls should follow those outlined in question 31.

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We appreciate the opportunity to comment on the questions above. The issues presented here are very complex and may warrant further discussion. We would welcome the opportunity to further discuss these issues with the staff and the Commission. If you have any questions or would like to discuss these issues, please contact Robert Kueppers at (212) 492-4241 or John Fogarty at (203) 761-3227.

Very truly yours,

/s/ Deloitte & Touche, LLP

cc: Chairman Christopher Cox
Commissioner Paul Atkins
Commissioner Roel Campos
Commissioner Annette Nazareth
Commissioner Kathleen Casey
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John White, Director, Division of Corporation Finance